

**BEFORE THE
CORPORATION COMMISSION OF THE STATE OF OKLAHOMA**

IN THE MATTER OF THE APPLICATION OF)
OKLAHOMA GAS AND ELECTRIC COMPANY)
FOR AN ORDER OF THE COMMISSION)
GRANTING PREAPPROVAL OF THE PURCHASE)
OF THE REDBUD GENERATING FACILITY)
AND AUTHORIZING A RECOVERY RIDER)

CAUSE NO. PUD 200800086

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CORPORATION COMMISSION
OF OKLAHOMA

Direct Testimony

of

James R. Hatfield

On behalf of

Oklahoma Gas and Electric Company

(REDACTED VERSION)

March 20, 2008

James R. Hatfield
Direct Testimony

1 Q. **Please state your name, position, by whom you are employed and business address.**

2 A. My name is James R. Hatfield. I am Senior Vice President and Chief Financial Officer of
3 Oklahoma Gas and Electric Company (OG&E or the Company). My business address is
4 321 N. Harvey Ave., Oklahoma City, Oklahoma 73101.

5

6 Q. **Please summarize your education and professional qualifications.**

7 A. I received a Bachelor of Science degree in Business Administration, with a functional
8 major in Accounting, from Central Missouri State University and a Masters in Business
9 Administration, with a concentration in Finance, from the University of Missouri, Kansas
10 City. I have worked in the utility business for over twenty years. Prior to joining OG&E
11 I worked for UtiliCorp United Inc. of Kansas City, Missouri (UtiliCorp) from 1980
12 through 1994. I held various positions with UtiliCorp, including the position of Assistant
13 Treasurer from 1988 to 1993. During the period January through August of 1994, I was
14 Vice President, Investor Relations and Corporate Secretary for Aquila Gas Pipeline
15 Corporation of San Antonio, Texas, an eighty-two percent owned subsidiary of UtiliCorp.
16 In August 1994, I joined OG&E. Before assuming my current responsibilities, I was Vice
17 President and Treasurer of the Company. I have held my current position of Senior Vice
18 President and Chief Financial Officer since November 1999. In my present position, I
19 have executive management responsibility for all accounting and financial functions at
20 OG&E.

1 Q. **Has the Oklahoma Corporation Commission (Commission) previously accepted**
2 **your professional qualifications?**

3 A. Yes.

4

5 Q. **What is the purpose of your testimony in this proceeding?**

6 A. I will discuss the relief that the Company seeks and requires with respect to our pending
7 acquisition of a 627 MW investment in an existing 1,230 MW gas-fired, combined-cycle
8 power generation facility located in Luther, Oklahoma. I also discuss the proper
9 accounting treatment for the transaction. Further, I illustrate the potentially harmful
10 financial implications to OG&E should the Company proceed with the acquisition when
11 sufficient relief is not granted by the Commission and explain the related increase in risk;
12 potential decrease in earnings; and, erosion to cash flow for the Company shareholders.

13

14 Q. **How is your testimony organized?**

15 A. My testimony is organized into the following eight sections:

16 SECTION I: Introduction

17 SECTION II: Context of Transaction

18 SECTION III: Relief Requested

19 SECTION IV: Accounting Treatment

20 SECTION V: Recovery Rider

21 SECTION VI: Financial Analysis

22 SECTION VII: Financial Community Perspective

23 SECTION VIII: Regulatory Treatment

SECTION I: INTRODUCTION

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Q. Please briefly describe the transaction which is the subject of this application?

A. In January of this year, Oklahoma Gas and Electric Company (“OG&E”) entered into a Purchase and Sale Agreement (“PSA”), an Asset Purchase Agreement (“APA”) and a Redbud Generating Facility Ownership and Operating Agreement (“O&O”). Through these agreements, OG&E, Oklahoma Municipal Power Authority (“OMPA”) and Grand River Dam Authority (“GRDA”) agreed to jointly acquire 100% of the assets of Redbud Energy LP (Redbud”) from Redbud Energy I, LLC, Redbud Energy II, LLC and Redbud Energy III, LLC.

Redbud consists of a 1,230 MW gas-fired, combined-cycle power generation facility (“Facility”) located in Luther, Oklahoma. After closing the purchase of 100% of Redbud through the PSA, OG&E plans to sell undivided interests of all the assets of Redbud to OMPA and GRDA pursuant to the APA, such that OG&E, OMPA and GRDA will own the Facility as tenants in common at the percentage of fifty-one percent (51%), thirteen percent (13%) and thirty-six percent (36%) respectively, thus leaving OG&E with an approximate 627 MW interest in the Facility.

Pursuant to the O&O, OG&E will be Operations Manager for the Facility.

Q. What is the purchase price of the Facility?

A. The base purchase price to be paid by OG&E for the Facility is \$852,000,000. The base purchase price, at closing, will be increased or decreased pursuant to the provisions of the PSA for changes to adjusted net working capital, certain ordinary and recurring items and changes to the value of Redbud’s un-depreciated inventory. After closing of the PSA,

1 OG&E will receive 36% and 13% of the total purchase price from GRDA and OMPA,
2 respectively. Therefore, OG&E's investment in the Facility will be \$434,520,000
3 [(\$852,000,000) * (51%) = \$434,520,000] plus or minus 51% of the aggregated
4 adjustments made at closing.

5
6 SECTION II: CONTEXT OF TRANSACTION

7 **Q. Please begin by generally highlighting OG&E's view of what this case is about.**

8 **A.** This case is specifically about preapproval for the purchase of the Redbud generating
9 facility. However, it is important to recognize that Redbud is a component of a much
10 broader plan to support the state's growing economy. OG&E is focused on providing
11 ample, reliable and safe electric power for its customers in Oklahoma so that our state can
12 fulfill its economic potential. To continue this service OG&E will require new
13 generation, substantial additional investment in electric infrastructure and investment in
14 environmental upgrades.

15 The Commission may recall that the Company outlined the needs to shore up overall
16 system reliability in Cause No. PUD 200500151. The new generation requirements are
17 described in detail in OG&E's Integrated Resource Plan. Finally, in keeping with our
18 ongoing commitment to a clean environment, OG&E continually evaluates its existing
19 power plants to be sure the Company maintains compliance with all government
20 environmental standards. This combined effort will require significant additional capital
21 investment as well.

1 To meet these requirements, OG&E has developed a capital investment program that will
2 benefit our state's economy and its people for years to come. Redbud has become a key
3 component of the Company's 6-year \$3.0 billion construction initiative.
4

5 **Q. Do OG&E and its customers have similar objectives with respect to the supply of**
6 **electricity to Oklahoma?**

7 **A.** Yes. OG&E believes that it is in a partnership with its customers with respect to ensuring
8 that electricity is provided in a reliable, safe and cost-efficient manner. If this objective is
9 attained then the customers receive reliable and safe service at just and reasonable prices.
10 When the Company is able to provide electricity as efficiently as possible its shareholders
11 should have the opportunity to earn a reasonable return on their investment.
12

13 **Q. Is Oklahoma alone in facing major investment requirements in the future?**

14 **A.** No. According to the Department of Energy's Energy Information Administration, the
15 United States will experience a 45 percent increase in demand for electricity from 3.8
16 trillion kilowatt hours to 5.5 trillion between 2005 and 2030. In fact, in OG&E's service
17 territory, we estimate there will be a 25% percent increase in demand for electricity
18 through 2017 which requires additional investment in generation facilities.

19 At the same time, the entire country is facing an aging electric infrastructure and a
20 concomitant threat to system reliability. Our way of life depends on a robust and reliable
21 power system. Updating our electric system infrastructure as well as increasing our
22 generating capability is critical. However the increase in generating capability must be
23 accomplished with sensitivity to increasing environmental standards. New pollution

1 control technologies give us the opportunity to meet Oklahoma's power needs while also
2 safeguarding the environment. Fortunately, Oklahoma is better positioned than most
3 states to deal with these challenges.

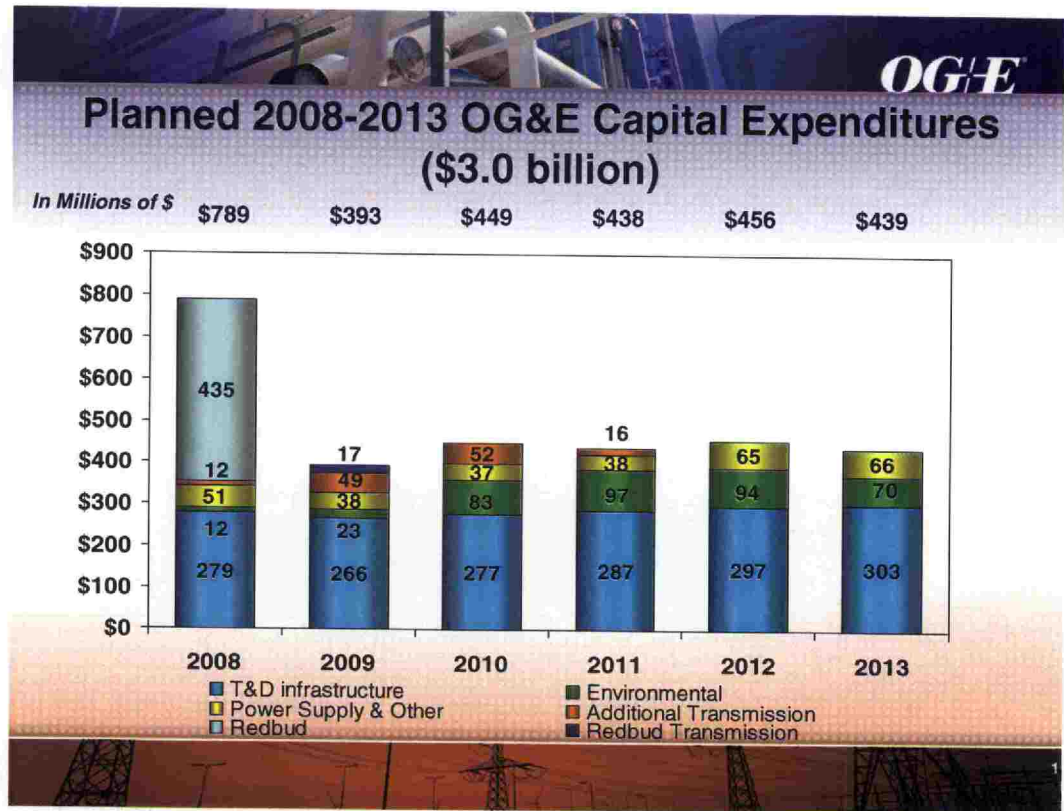
4
5 Q. **Please explain.**

6 A. The Commission and the Oklahoma Legislature have taken innovative action in recent
7 years to encourage the development of a plentiful supply of electricity to meet
8 Oklahoma's increasing demand. Because of the actions of the Oklahoma Legislature and
9 the Commission, OG&E is able to utilize a preapproval process that is not available to
10 utilities in many other states.

11
12 Q. **You mentioned that the Company intends to invest approximately \$3.0 billion over
13 the next six years. What are the key elements of the 6-year construction initiative?**

14 A. In Chart 1 on the following page, I present a diagram of the various elements in the
15 capital expenditures budget for 2008-2013. As you can see, the 6-year construction
16 initiative consists of three primary categories.

Chart 1



2

3

First, OG&E proposes to purchase a 51% ownership interest in the Redbud facility and invest in its share of required transmission upgrades, if any. The demand for electricity on the OG&E system is estimated to grow at a rate of about 2.1% annually over the next decade. As OG&E witnesses Jesse Langston and Leon Howell will describe in more detail, we project the need for more capacity in the 2009-2012 timeframe and Redbud helps meet that need.

4

5

Second, OG&E will continue to aggressively invest in its infrastructure. Over the past several years, the Company has significantly increased capital investment in its infrastructure—transformers, poles, cable, etc. By increasing investment and proactively prioritizing and addressing issues, OG&E has increased reliability and reduced customer

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1 inconvenience. However, the level of investment in this area will continue to grow as
2 OG&E's existing infrastructure ages and as the Company meets the requirements of
3 growing demand.

4 Third, during the course of the 6-year construction initiative, OG&E will add air emission
5 control equipment to some of the Company's existing power plants. Such equipment
6 reduces the levels of emissions such as sulfur dioxide, nitrogen oxide and mercury.
7 Installation of this equipment will bring the Company into compliance with increasingly
8 stringent federal clean air emission standards and will enable OG&E's customers to
9 continue to have access to the benefits of low-cost coal as a generating fuel.

10
11 **Q. Are there any other investments OG&E could undertake in the near future?**

12 **A.** Yes. There are several investments OG&E hopes to undertake that are not yet included in
13 the budgeted 6-year construction initiative that could increase our capital expenditures to
14 an amount significantly above \$3.0 billion for this period.

15 OG&E will participate in the competitive bidding process for the 600 MW of wind
16 announced by the Company in 2007. Additionally, transmission facilities will be required
17 to connect any wind generation in western Oklahoma to the grid and deliver it to load
18 centers throughout Oklahoma. OG&E stands ready to invest in those projects. Finally, the
19 Commission is currently studying the effects of the December 2007 ice storm and the
20 possibility of moving electric lines underground. The Company may need to invest in
21 these types of projects as well. When it is determined how much OG&E will invest in
22 these areas over the next six years, the \$3.0 billion budget will be increased.

1 Q. **Has the Company taken steps to hold down costs?**

2 A. Throughout its history, and especially for the past 20 years, OG&E has worked hard to
3 streamline its operations. Like many corporations, we have learned to do more with less.
4 By implementing new technology and improving our processes, we have been able to
5 reduce our work force to half its 1987 size. We have eliminated facilities across our
6 service territory without affecting service quality. These efficiencies have allowed us to
7 maintain reliable, low cost services to our customers more economically. While the
8 average OG&E customer's usage has increased more than 24% in this 20-year period, the
9 average non-fuel cost of a residential kilowatt hour in 2007 is less than it was in 1987. In
10 fact, we have had nine rate decreases over the past 20 years, compared to only one rate
11 increase during that time.

12

13 Q. **How do OG&E's rates compare to other electric utilities?**

14 A. According to Edison Electric Institute, Typical Bills and Average Rates Report—
15 Summer 2007, the Company's rates are approximately 28% lower than the national
16 average, 17% lower than the regional average and 2% lower than the State of Oklahoma
17 average cost of electricity. This comparison was based on what customers paid for
18 electricity during the 12-month period ending June 30, 2007. OG&E witness Roger
19 Walkingstick addresses this rate comparison in his testimony.

SECTION III: RELIEF REQUESTED

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Q. What relief is OG&E requesting of the Commission in this proceeding?

A. The Company is requesting the Commission to issue an order that includes the following findings: (i) OG&E’s decision to purchase a 51% interest in Redbud is prudent; (ii) the generation facility is used and useful upon closing the transaction; (iii) authorization of a rider to recover Redbud’s annual revenue requirement until OG&E’s next rate case is completed and new rates implemented;¹ and (iv) the full investment or purchase price, return on and amortization for transaction costs, operation and maintenance expenses, depreciation and ad valorem taxes related to Redbud shall be included in the Company’s cost of service in its next rate case. My testimony explains in more detail the requested relief in this proceeding.

Q. Will the investment that OG&E seeks recovery for include transaction costs?

A. Yes. OG&E seeks to include its projected transaction costs of \$3.8 million as part of the Company’s total rate base investment for the Facility. To comply with financial accounting standards, these transaction costs should be included on the balance sheet as a regulatory asset and not as part of the plant investment. These costs will increase the Company’s investment in rate base for Redbud to approximately \$438.3 million. The transaction costs include expenses for financial advisors, attorneys, engineers, other consultants and miscellaneous other fees and expenses. These services and costs were a necessary component in facilitating the acquisition of the Redbud facility. The transaction

¹ OG&E may be required to invest in transmission plant in order to facilitate delivery of electricity for Redbud or possibly for transmission investments required by FERC. The Company is not proposing to recover any transmission costs through the recovery rider. However, those investments will be included in the cost of service for the next rate case filed by OG&E. These potential investments are discussed later in my testimony.

1 costs were prudently incurred and should be recoverable through OG&E's electric rates.
2 Therefore, OG&E seeks recovery through the rider and permanent rates for the
3 transaction costs as a component of its rate base.
4

5 **Q. Why does OG&E seek the above relief prior to the purchase of Redbud?**

6 **A.** Redbud is only one component of OG&E's capital investment initiative discussed above
7 in my testimony. As stated earlier, over the next six years, OG&E expects to invest at
8 least \$3.0 billion in reliability, including infrastructure upgrades and new generation, as
9 well as mandated environmental projects. These capital expenditures are required to
10 maintain safe and reliable service for existing customers, as well as the demands of future
11 customers for electricity created by economic growth in our service area.

12 Without considering the potentially significant additional investments in wind generation,
13 new transmission lines and underground facilities, this \$3.0 billion in budgeted capital
14 expenditures far exceeds OG&E's historical capital expenditure levels, even those in the
15 late 1970s and early 1980s when the Company was building its existing coal units. The
16 Company's ability to ensure long-term reliability and meet federal and state
17 environmental standards depends on whether OG&E can adequately access the capital
18 markets and timely recover the cost of these investments. The Company is requesting
19 preapproval for the purchase of and recovery for Redbud costs in order to (i) maintain
20 OG&E's ability to access the capital markets on efficient terms and (ii) provide
21 reasonable earnings for shareowners.

SECTION IV: ACCOUNTING TREATMENT

1
2 Q. **What is the accounting treatment for the transaction costs incurred for the**
3 **acquisition of Redbud?**

4 A. As I discussed previously, OG&E expects to incur transaction costs of approximately
5 \$3.8 million for the acquisition of Redbud. OG&E seeks to record its transaction costs in
6 a Commission-authorized regulatory asset and amortize the regulatory asset over the
7 remaining depreciable life of the Facility. OG&E seeks recovery for the return on the
8 unamortized balance of and amortization expense for the regulatory asset in the rider and,
9 subsequently through permanent rates.

10
11 Q. **Does OG&E believe the Federal Energy Regulatory Agency (“FERC”) may require**
12 **the Company to record an acquisition adjustment for the purchase of the Redbud**
13 **facility?**

14 A. OG&E believes the proper accounting treatment is to record the asset at its purchase
15 price. However, the Company may be required by FERC to record the amount paid above
16 original cost less accumulated depreciation as an acquisition adjustment. That accounting
17 treatment may be required pursuant to a recent FERC order.²

18
19 Q. **Is the base purchase price for the Redbud facility greater than original cost less**
20 **accumulated depreciation?**

21 A. Yes. OG&E’s investment in Redbud will be approximately \$435.0 million. OG&E’s 51%
22 share of Redbud’s book value at the closing, based on original cost less accumulated
23 depreciation, is expected to be approximately \$286.0 million. Therefore, OG&E’s share

² Please see FERC order in Docket No. EC07-31-000 issued February 1, 2007.

1 of the purchase price is approximately \$149.0 million [(\$435.0 million - \$286.0 million)
2 = \$149.0 million] greater than original cost less accumulated depreciation.

3
4 **Q. If OG&E is required to record \$149.0 million as an acquisition adjustment, should**
5 **the Commission allow the full purchase price of \$435.0 million in rate base?**

6 **A.** Yes. OG&E witnesses Mr. Jesse B. Langston, Mr. Leon Howell and Mr. John J. Reed
7 have collectively demonstrated that the acquisition of and purchase price for the Redbud
8 facility was prudently determined and negotiated. Specifically, these witnesses clearly
9 explain that:

10 1) OG&E's resource planning analyses support a decision to acquire a 51%
11 interest in the Redbud facility because it is part of the lowest reasonable cost
12 portfolio when taking into account reliability of supply, capacity market risks and
13 construction cost risk;

14 2) OG&E's business rationale and decision-making process employed during the
15 bid and negotiation process was thorough and comprehensive and conducted at
16 arms-length;

17 3) OG&E's customers will enjoy significant benefits from the Company acquiring
18 a controlling interest in Redbud; and,

19 4) The purchase price paid for Redbud is reasonable based on: (a) a DCF analysis;
20 (b) a current construction cost analysis; and, (c) a comparable transaction
21 analysis.

22 Even if OG&E is required to record \$149.0 million as an acquisition adjustment, the
23 Company has demonstrated that the amount paid was reasonable and less than new

1 construction cost and other options. That is, if the Company had decided to construct
2 plant comparable to the proposed investment in Redbud, the costs would have been
3 greater than the purchase price agreed to.
4

5 **Q. Does OG&E need to be authorized to recover any recorded acquisition adjustment**
6 **through the proposed rider and subsequently through permanent rates?**

7 A. Yes. No matter what accounting treatment FERC authorizes, OG&E simply cannot lose
8 an opportunity to recover an investment of \$149.0 million in utility plant. The impact to
9 shareholder equity would be too significant to endure and, therefore, it would not be a
10 prudent business decision to proceed with the transaction under that circumstance.
11 Therefore, the Company needs the Commission order to specifically authorize the
12 recovery of the acquisition adjustment through the rider and subsequently through
13 permanent rates.
14

15 **Q. Is it common for assets to be sold at prices above book value?**

16 A. Yes. Assets are generally sold at fair value as negotiated by the buyer and seller. The fair
17 value of assets is generally different than book value. If a utility expects to purchase a
18 utility asset from another company, it must be willing to pay the fair value as determined
19 by rigorous arms-length negotiations.
20

21 **Q. What causes fair value to differ from book value?**

22 A. The book value of an asset is just the original cost less accumulated depreciation. The
23 simplest way to conceptually describe the difference between the fair value and book

1 value of assets is to consider a common technique used by financial experts to determine
2 the fair value of an asset. That technique is called the discounted cash flow (“DCF”)
3 method. Using the DCF method, an analyst estimates, over the functional life of the asset,
4 the annual cash inflows and annual cash outflows attributable to the ownership and
5 operation of that asset. That is, the analyst estimates all cash revenues and cash
6 expenditures it believes will occur when the owner endeavors to maximize profits from
7 the use of that asset. The fair value of the asset is represented by the discounted net
8 present value of those estimates of cash revenues and cash expenditures using the after-
9 tax discount rate of the company.

10
11 **Q. In this case would the owners of Redbud have sold the Facility for less than fair**
12 **value?**

13 **A. No. The owners would not have been motivated to sell the Redbud facility for less than**
14 **fair value. If they did so, the owners would receive less value for the Facility than either**
15 **retaining the asset for themselves or selling it at fair value to another interested buyer.**

16
17 **Q. Did OG&E use the DCF approach as one tool for valuing the Facility?**

18 **A. Yes. As described in the testimony of OG&E witness Mr. John J. Reed, the DCF model**
19 **was one of several valuation techniques employed by the Company in negotiating the**
20 **purchase price.**

SECTION V: RECOVERY RIDER

1
2 Q. **Please explain the proposed rider for the recovery of the revenue requirements for**
3 **2009?**

4 A. OG&E is requesting the current recovery, through a rider, for the revenue requirements
5 which will result from the acquisition of a 51% interest in the Facility. These revenues
6 will be the difference between (1) the total Oklahoma jurisdictional revenue requirement
7 including OG&E's 51% interest in the Facility and (2) the total Oklahoma jurisdictional
8 revenue requirement excluding OG&E's 51% interest in the Facility³. That is, OG&E is
9 seeking current recovery, through the rider, for the revenue requirements for expenses,
10 other than fuel expense, and return on investment incurred due to its investment in the
11 Facility.

12 OG&E requests the recovery of these revenue requirements through a rider mechanism to
13 be described by OG&E witness Roger D. Walkingstick. OG&E seeks recovery of the
14 rider for the period beginning with the date energy is provided from Redbud to OG&E's
15 customers and ending with the implementation of permanent rates ordered by the
16 Commission upon the conclusion of OG&E's next rate case. OG&E expects the rider to
17 be in effect for approximately one year.⁴

18
19 Q. **What is the amount of revenue requirements for which OG&E seeks recovery?**

20 A. OG&E has calculated the estimated revenue requirements for the twelve months of 2009.
21 The total amount allocated to Oklahoma jurisdictional customers for 2009 is \$75.4

³ The rider will not be designed to collect the fuel and fuel related expenses authorized for recovery through the Fuel Cost Adjustment.

⁴ With Commission approval, OG&E anticipates closing the transaction in 2008. Further, OG&E expects to file its next rate case in 2009 using a 2008 test year.

1 million. The revenue requirements were determined based on an estimate for the cost of
2 service for Redbud once OG&E owns and operates the unit on behalf of its customers.
3 The cost of service for Redbud collected through the rider would include a return on
4 Redbud's rate base including transaction costs, amortization of transaction cost,
5 depreciation expense, operations and maintenance expense other than fuel expense,
6 related state and federal income tax expense and other tax expense.

7
8 **Q. Will OG&E incur any investment in transmission plant with respect to the Redbud**
9 **acquisition?**

10 A. It is possible that OG&E will need to make certain investments in transmission plant with
11 respect to Redbud. Those investments may include certain upgrades and mitigation
12 projects to increase import capability in order to resolve potential competitive concerns of
13 the FERC.⁵

14 OG&E witness Phillip L. Crissup estimates that the costs for these projects could be up to
15 \$17.0 million. However, OG&E does not seek to include any potential transmission plant
16 investments in the revenue requirements for the rider. If transmission expenditures are
17 incurred, those investments will be addressed in OG&E's next rate case.

18
19 **Q. Does the collection of the revenues through the rider help phase in rate increases for**
20 **OG&E's Oklahoma customers?**

21 A. Yes. OG&E plans to file a rate case in 2009 based on a 2008 test year. The revenue
22 requirements for that test year would necessarily include the cost of service for our

⁵ OG&E Witness Phillip L. Crissup discusses these potential transmission projects in his testimony for these proceedings.

1 proposed investment in Redbud. With Commission approval of the rider, OG&E is able
2 to phase in its rate increase over two years instead of one year. That is, OG&E could
3 begin collecting the revenue requirements for Redbud in 2009 instead of as part of a
4 larger rate increase beginning in 2010. The phase in of rate increases over the 2009-2010
5 time period helps customers avoid the shock of a more significant increase in 2010.

6
7 **Q. Does OG&E believe there needs to be a true-up of these estimated revenue**
8 **requirements recovered through the rider?**

9 A. Yes. It is prudent to implement a true-up mechanism to protect the customers and
10 shareholders. The true-up mechanism is described in the testimony of OG&E Witness
11 Roger D. Walkingstick. The true-up mechanism is designed to insure that costs collected
12 through the rider will agree with the actual revenue requirements for Redbud. As
13 explained by Mr. Walkingstick, the company will file a true-up report in March 2010.
14 The Commission Staff and representatives of the other parties will be able to review and
15 audit the true-up at that time.

16
17 **Q. Is it possible for the rider to be in effect for months other than those for 2009?**

18 A. Yes. OG&E is seeking the rider for the full period of time beginning after the closing of
19 the APA and contemporaneously with Redbud supplying energy to our customers and
20 ending with the implementation of permanent rates ordered by the Commission upon the
21 conclusion of OG&E's next rate case. If that period begins before January 1, 2009 or
22 ends later than December 31, 2009, OG&E requests to recover the revenue requirements

1 for those additional months too. OG&E shall use the same methodology described above
2 to calculate revenues for recovery through the rider for any additional months.

3
4 **Q. In your opinion, is the relief requested fair, just and reasonable?**

5 **A. Yes.**

6
7 **SECTION VI: FINANCIAL ANALYSIS**

8 **Q. Is the recovery of the revenue requirements for the Facility important to earnings**
9 **and the financial status of OG&E?**

10 **A. Yes.** In order to demonstrate the significance of OG&E's recovering the additional
11 revenues through the rider in 2009, and subsequently through its new permanent rates in
12 2010, I have performed standard financial analysis, under specific scenarios of (1) certain
13 forecasted financial ratios for OG&E for 2009, the year immediately after the acquisition
14 of Redbud and before implementation of new permanent rates in 2010;⁶ and, (2) certain
15 forecasted financial ratios for OG&E for 2010, the year after implementation of new
16 permanent rates in 2010.

17 Further, I have calculated, under specific scenarios, OG&E's forecasted regulatory
18 earnings and return on equity for each of 2009 and 2010.

19
20 **Q. Is it important for OG&E to maintain financial ratios at certain levels?**

21 **A. Yes.** Usually, the better a firm's financial ratios, the lower its debt costs. Lower debt
22 costs result in lower utility rates for OG&E's electric customers. At a minimum, OG&E

⁶ On page 15 of Order No. 524078 the Commission required that "...OG&E is directed to file a general rate proceeding in a time frame that will permit the Commission to issue a general rate order not later than December 31, 2009..."

1 must maintain its financial statements such that its debt is considered investment grade. If
2 it does not, OG&E's debt costs would be significantly negatively affected. However,
3 even if the Company's debt remains investment grade, any incremental decline in these
4 financial ratios would almost certainly increase the cost of future debt.

5
6 **Q. Why do negative impacts to financial ratios increase debt cost?**

7 **A.** When the financial ratios discussed here become less favorable, investors and the
8 financial community perceive the cash flow of the Company to be more risky. There is a
9 direct causal relationship between interest rates and risk. Everything else constant, as
10 business or financial risk increases, so does the Company's cost of debt. This causal
11 relationship exists whether a company issues junk bonds or if its debt is investment
12 grade.

13
14 **Q. What do you mean by investment grade?**

15 **A.** Initially, the term "investment grade" was used by regulatory agencies to identify debt
16 securities eligible for investment by financial institutions such as banks, insurance
17 companies, and savings and loan associations. Over time, this term gained widespread
18 usage throughout the investment community. For example, according to Standard &
19 Poor's ratings system, debt securities rated in the four highest categories of, "AAA",
20 "AA", "A", "BBB", are recognized as being investment grade. Debt securities rated
21 "BB" or below generally are referred to as "speculative grade." Sometimes the term
22 "junk bond" is used for this category of more risky debt. Debt securities rated "BB", "B",

1 “CCC”, “CC”, and “C” are regarded as having speculative characteristics. ‘BB’ indicates
2 the least degree of speculation, and “C” the highest.

3
4 **Q. Please identify the scenarios for which OG&E has calculated forecasted earnings**
5 **and financial ratios?**

6 A. OG&E has determined forecasted earnings and financial ratios under two scenarios. The
7 first scenario assumes that OG&E is granted full recovery of the revenue requirements
8 for the Facility. For this scenario, OG&E assumes the revenue requirements are
9 recovered for 2009 through the proposed rider and for 2010 through then authorized
10 permanent rates. Under this scenario, OG&E could prudently proceed with the
11 acquisition of Redbud.

12 The second scenario assumes that OG&E is not granted recovery of the revenue
13 requirements for the Facility either through the rider in 2009 or through permanent rates
14 for 2010. Proceeding with the transaction under these circumstances would not be a
15 prudent decision of OG&E’s management; however, this scenario is provided to
16 demonstrate the negative impact to the Company’s financial ratios and earnings if OG&E
17 were to acquire the Facility without the requested relief.

18 In order to compare these two scenarios for each of 2009 and 2010, the Company
19 calculated forecasted earnings and financial ratios for:

- 20 1. Redbud purchase with full rider recovery for 2009;
- 21 2. Redbud purchase with full recovery through rates for 2010;
- 22 3. Redbud purchase without rider recovery for 2009; and,
- 23 4. Redbud purchase without recovery through rates for 2010.

1 Q. **What forecasted ratios have OG&E calculated for each of the scenarios above?**

2 A. The Company has calculated the: Annual Funds from Operations (“FFO”) Interest
3 Coverage⁷; Annual FFO Debt Coverage⁸; Debt/Total Capital⁹; Return on Equity¹⁰; and,
4 the Regulatory Return on Equity.

5
6 Q. **How is financial ratio analysis used by financial experts?**

7 A. Financial ratio analysis is used by credit rating organizations and financial analysts to
8 measure the general financial condition and creditworthiness of an obligor, or the
9 creditworthiness of an obligor with respect to a particular debt security or other financial
10 obligation, supplemented by other relevant risk factors. Similarly, these analyses can
11 provide valuable information for regulatory commissions as to the financial viability of
12 regulated utilities and, thus, expectations for a regulated utility’s future ability to provide
13 reliable and sufficient service at just and reasonable prices.

14 It also allows a regulatory commission to understand the relationship between capital
15 costs and the revenues collected through utility rates. That is, when a utility is not
16 allowed to recover costs through its rates, that company’s cash flow and earnings are
17 negatively impacted. When a company’s cash flow and earnings are negatively impacted,
18 financial ratios are damaged and the company’s cash flow is perceived more risky, thus
19 its debt costs and costs of equity can increase.

⁷ For purposes of calculating this statistic throughout these calculations, the Annual FFO Interest Coverage = Cash flow from operations (excluding net changes to working capital) plus interest expense divided by interest expense.

⁸ For purposes of calculating this statistic throughout these calculations, the Annual FFO Debt Coverage = Cash flow from operations (excluding net changes to working capital) divided by an adjusted year-end debt balance.

⁹ For purposes of calculating this statistic throughout these calculations, the Debt/Total Capital = Adjusted year-end debt balance divided by year-end total capital balance.

¹⁰ For purposes of calculating this statistic throughout these calculations, the Return on Equity = Operating Income divided by year-end common equity balance.

1 Q. **Is the usefulness of financial ratio analysis dependent on the quality of the financial**
2 **information used in the analysis?**

3 A. Yes. A firm's profitability, financial leverage and cash flow are important factors for
4 determining its financial viability and creditworthiness. Financial ratio analysis is a
5 technique often used to evaluate these factors. However, the value placed on information
6 derived from financial ratio analysis is strictly dependent on the credibility of the data
7 input to the analysis. Also, financial ratio analysis does not tell the whole story regarding
8 a firm's financial condition. There may be relevant qualitative factors related to
9 management's business and financial philosophy, corporate diversification and corporate
10 structure considerations, and exposure to legal judgments or regulatory penalties. There
11 may be other relevant quantitative factors overlooked in the analysis too.

12 Even though financial ratios are not the only information considered for the measure of a
13 company's risk and financial viability, its use is less subjective than many other measures
14 and is often the most dominant factor considered. Regardless, of other factors, there is a
15 strong relationship between financial ratios and capital costs, and analysis of them can be
16 performed in isolation of those qualitative factors. This is the case because those other
17 factors are likely unchanged as a result of ratemaking treatment. Keep in mind here that I
18 am demonstrating the impact on the utility from the regulatory treatment granted in this
19 proceeding.

20
21 Q. **Is forecasted information used in ratio analysis?**

22 A. Yes. In calculating certain of the ratios, analysts use forecasted cash flow and earnings
23 data. Specifically, for the Company's analysis here, we used cash flow and earnings

1 estimates for 2009 and 2010 developed by the Company's finance group. In calculating
2 other of the ratios, analysts use forecasted asset, equity and debt balances. Here, the
3 Company used forecasted asset, equity and debt balances also for 2009 and 2010. The
4 forecasted financial statements used as a basis for these estimates are developed with
5 great care by the Company and are subsequently approved by OG&E's Board of
6 Directors. Further, the forecasted financial information is subsequently used by the
7 Company to help determine dividend policy and to provide information to ratings
8 agencies. Therefore, these financial ratios are supported by financial information closely
9 examined and scrutinized by OG&E.

10
11 **Q. Could you provide an example of how a company's balance sheet may not provide**
12 **all the relevant information needed to value assets and liabilities in the analysis?**

13 **A.** A company's debt balance recorded in its accounting books may be understated from not
14 including off-balance-sheet financing, thus, understating financial leverage. Off-balance-
15 sheet financing includes obligations such as operating leases, debt of joint ventures and
16 unconsolidated subsidiaries, guarantees, take-or-pay or prepaid gas contracts and
17 obligations, receivables that have been factored or otherwise used as security for a loan
18 and contingent liabilities, such as potential legal judgments or lawsuit settlements. When
19 a company uses a material amount of off-balance-sheet financing, the analysis should
20 take these facts into account by adjusting debt balances to include imputed debt.

1 Q. **Please explain why a company's cash flow is important?**

2 A. Like for all corporations, OG&E's interest and principal payments for debt cannot be
3 paid out of accounting earnings. Instead, these payments have to be made with cash.
4 Although there is usually a strong relationship between cash flow and profitability based
5 on accounting earnings, many transactions and accounting entries affect one and not the
6 other. Analysis of cash flow patterns can reveal a level of debt-servicing capability that is
7 either stronger or weaker than might be apparent from analyzing accounting earnings.
8 Cash flow analysis is the most critical of all financial ratio analysis. It takes even more
9 importance for junk bond issuers. While companies with investment grade ratings
10 generally have convenient access, on reasonable terms, to external cash to cover
11 temporary shortfalls, junk bond issuers lack this degree of flexibility and have fewer
12 alternatives (on reasonable terms) to internally generated cash for servicing debt. That
13 said, sustained declines in cash flow affect the risk of otherwise healthy companies and,
14 therefore, increase debt costs to customers.

15
16 Q. **Please discuss how you analyzed the company's cash flow?**

17 A. I examined the cash flow for OG&E for the future annual periods of 2009 and 2010 under
18 each scenario. I calculated two financial ratios commonly used to measure adequacy of
19 cash flow. That is, I calculated the FFO Interest Coverage and FFO Debt Coverage ratios.
20 The objective here, as for all my financial analysis herein, is to estimate the negative
21 impact to the Company from the Commission not allowing current and full recovery for
22 the revenue requirements for the Redbud acquisition.

1 Q. **Did you also calculate financial leverage ratios for each of the scenarios for OG&E?**

2 A. Yes, I did. I calculated OG&E's Debt/Total Capital ratio for the future annual periods of
3 2009 and 2010 under each scenario. The Commission will see below that these particular
4 ratios are not affected to the same extent as the cash flow and earnings ratios.
5

6 Q. **Is a company's return on equity an important ratio for financial analysis?**

7 A. Yes. Earnings potential is a critical determinant of credit protection. A utility that
8 generates higher operating margins and returns on equity has a greater ability to generate
9 equity capital internally, attract capital externally, and withstand business adversity.
10 Earnings power ultimately attests to the value of the firm's assets and influences its stock
11 price.
12

13 Q. **Did you calculate the return on equity for each of the scenarios for OG&E?**

14 A. Yes. I examined the return on equity for OG&E for the future annual periods of 2009 and
15 2010 under each scenario.
16

17 Q. **Did you calculate a "Regulatory" return on equity for OG&E for each of the
18 scenarios?**

19 A. Yes. The calculation of return on equity, for regulatory purposes, should only consider
20 those revenues, expenses, sales volumes, investments and capital of OG&E used for
21 providing electric utility service to its customers. I refer to the calculation of return on
22 equity, for regulatory purposes, as the "regulatory" return on equity. OG&E's revenues,
23 expenses and capital used for unregulated purposes are excluded from this ratio. In

1 OG&E's most recent rate case, it was authorized to earn a "regulatory" return on equity
2 of 10.75%.

3
4 **Q. Please summarize the specific scenarios used to demonstrate the importance of the**
5 **financial relief sought from the Commission?**

6 A. The forecasted analysis for 2009 was conducted under two assumptions. One scenario
7 for 2009 includes recovery of the revenue requirements through the proposed rider and
8 the other does not. The forecasted analysis for 2010 was also conducted under two
9 assumptions. One scenario for 2010 includes recovery of the revenue requirements
10 through permanent rates and the other does not. Because OG&E's next rate case is
11 scheduled for 2009, permanent rates including the Facility are expected to be
12 implemented by 2010 based on a 2008 test year.

13 Comparing these two scenarios, OG&E is able to demonstrate to the Commission the
14 negative impact to its financial ratios and earnings from the Company not receiving the
15 revenue requirements for the Facility either through: (1) the rider for 2009 or (2)
16 permanent rates for 2010.

17
18 **Q. Please provide the results of your analysis for the two scenarios for 2009.**

19 A. In Chart 2, I present the results for the analysis of financial ratios, return on equity and
20 "regulatory" return on equity for 2009 under each scenario. The chart also shows the
21 percentage change in the results under the two scenarios.

Chart 2

	2009				
	FFO Interest Coverage	FFO Debt Coverage	Debt/Total Capital	Return on Equity	Regulatory Return on Equity
W/Rider	██████	██████	██████	██████	██████
W/O Rider	██████	██████	██████	██████	██████
% Change	██████	██████	██████	██████	██████

2 Q. Please discuss the change in these ratios from one scenario to the other for 2009.

3 A. The Commission can see that OG&E's cash flow, leverage and earnings ratios erode if
 4 OG&E does not recover the revenue requirements for the Redbud facility through the
 5 rider for 2009. In terms of the cash flow coverage ratios, the FFO/Interest and FFO/Debt
 6 ratios decrease ██████ and ██████, respectively. OG&E's debt as a percentage of total
 7 capital increases by ██████. These changes in the cash flow and leverage ratios all
 8 represent a weakening of the Company's credit metrics and, thus, an increase in financial
 9 risk.

10 There is even a more significant negative impact to OG&E's return on equity and
 11 "regulatory" return on equity for 2009. OG&E's return on equity and "regulatory" return
 12 on equity for 2009 decrease to ██████ and ██████, respectively. The "regulatory" return on
 13 equity here is significantly below OG&E's currently authorized rate of 10.75%.
 14 Furthermore, these decreased levels of return on equity and "regulatory" return on equity
 15 represent declines of ██████ and ██████, respectively, relative to those earnings levels
 16 OG&E could achieve with recovery of the revenue requirements for Redbud through the
 17 rider.

1 Q. Please provide the results of your analysis for the two scenarios for 2010.

2 A. In Chart 3, I present the results for the analysis of financial ratios, return on equity and
 3 “regulatory” return on equity for 2010 under each scenario. The chart also shows the
 4 percentage change in the results under the two scenarios.

5 Chart 3

	2010				
	FFO Interest Coverage	FFO Debt Coverage	Debt/Total Capital	Return on Equity	Regulatory Return on Equity
W/Rate Relief	██████	██████	██████	██████	██████
W/O Rate Relief	██████	██████	██████	██████	██████
% Change	██████	██████	██████	██████	██████

6
 7 Q. Please discuss the change in these ratios from one scenario to the other for 2010.

8 A. Similarly, as for 2009, the Commission can see that OG&E’s cash flow, leverage and
 9 earnings ratios erode if OG&E does not recover the revenue requirements for the Redbud
 10 facility through permanent rates for 2010.

11 In terms of the cash flow coverage ratios, the FFO/Interest and FFO/Debt ratios decrease
 12 ██████ and ██████, respectively. OG&E’s debt as a percentage of total capital increases
 13 by ██████. These changes in the cash flow and leverage ratios all represent a continuation
 14 of OG&E’s weakened credit metrics and increase in financial risk.

15 As for 2009, there is a significant negative impact to OG&E’s return on equity and
 16 “regulatory” return on equity for 2010. OG&E’s return on equity and “regulatory” return
 17 on equity for 2010 decrease to ██████ and ██████, respectively. Furthermore, these
 18 decreased levels of return on equity and “regulatory” return on equity represent declines

1 of [REDACTED] and [REDACTED], respectively, relative to those earnings levels OG&E could achieve
2 with recovery of the revenue requirements for Redbud through permanent rates.
3

4 **Q. If the Commission denies recovery for Redbuds' revenue requirements through the**
5 **rider and permanent rates, should OG&E proceed with the acquisition of the**
6 **Facility?**

7 A. No. Given the substantial negative impact to OG&E's forecasted cash flow and earnings
8 for 2009 and 2010, the Company should not proceed with the acquisition of Redbud
9 without being granted its requested relief.
10

11 **Q. If the Commission denies recovery for Redbuds' revenue requirements through the**
12 **rider and permanent rates, does that finding impact OG&E's business risk?**

13 A. Yes. If the Commission denies recovery for the revenue requirements through the rider
14 and, subsequently, through permanent rates, investors and credit ratings agencies would
15 attribute a greater degree of business risk to OG&E's risk profile. That means that
16 potential investors in OG&E's securities would consider cost recovery risks for future
17 Company investments. Therefore, even though OG&E would not proceed with the
18 acquisition of Redbud under those circumstances, capital costs for the Company's
19 expenditures for its 6-year construction initiative could be greater because of the
20 incremental business risk.

1 Q. **How would OG&E likely fill capacity requirements absent approval of the relief**
2 **sought here?**

3 A. If OG&E did not invest in Redbud, most likely the Company would enter purchase power
4 agreements (“PPA”) for its near term requirements.
5

6 Q. **How would using PPAs affect OG&E’s financial standing?**

7 A. The Company’s financial metrics, as determined by S&P, would include an imputation of
8 debt attributable to the PPA. The effect of that imputation of debt would be to cause a
9 deterioration of the Company’s cash flow and leverage ratios. The negative impact to the
10 cash flow ratios would have an additional incremental increase in debt costs beyond that
11 increase caused by the financial community’s perception of greater regulatory and
12 business risk.
13

14 SECTION VII: FINANCIAL COMMUNITY RESPONSE

15 Q. **If OG&E acquires Redbud, will the financial community be concerned with whether**
16 **OG&E receives adequate relief from the Commission?**

17 A. Yes. Debt and equity investors that currently invest in OG&E’s debt and equity,
18 respectively, are concerned with the cash flow and earnings of the Company. Further,
19 debt and equity investors considering an investment also evaluate OG&E’s financial
20 metrics in making an investment decision.

21 For investors in electric utility securities, it is extremely important that the utility receive
22 recovery through its rates for prudent investments and expenses incurred to provide
23 service to its customers. If OG&E does not receive timely recovery for all costs incurred

1 to purchase and operate Redbud, we have demonstrated that the Company's earnings,
2 debt leverage and cash flow can be negatively affected. Under those circumstances,
3 current investors' investments in OG&E Energy's stock and publicly traded debt should
4 lose value and new investors' return requirements for an investment in the Company's
5 securities will increase. It follows that OG&E's current and incremental cost of debt and
6 equity capital increases requiring its return on rate base to be higher for customers.

7
8 **Q. If OG&E is not granted sufficient relief to go forward with the purchase of Redbud,**
9 **does that impact the financial community's outlook for OG&E's 6-year construction**
10 **initiative?**

11 A. Yes. Insufficient relief for OG&E's investment in Redbud would create concerns as to
12 whether the other investments OG&E plans to undertake will be adequately funded
13 through utility rates. As a result, current and prospective investors and creditors of
14 OG&E could require a greater return on investments in OG&E's securities and other debt
15 instruments. Subsequently, utility rates would need to be increased to cover greater
16 capital costs.

17
18 **Q. Does the business risk for OG&E increase when it is not allowed to recover material**
19 **investments through rates?**

20 A. Yes. We have demonstrated that the financial ratios and earnings of OG&E can be
21 decreased when sufficient rate relief is not granted. However, when material investments
22 and related operating expenses are not allowed recovery through utility rates, the ratings
23 agencies and financial community attribute a greater degree of business risk to the utility.

1 Therefore, if OG&E is not allowed recovery of the Redbud investment through the rider
2 and subsequently through permanent rates, investors and rating agencies will attribute
3 greater risk to an investment in the Company's securities, thus causing further increases
4 in capital costs.

5
6 **Q. Concerning your discussion of the financial community's perception of business**
7 **risk, has the financial community expressed concern regarding the current**
8 **regulatory environment in Oklahoma?**

9 A. Yes.

10
11 **Q. Please explain.**

12 A. Lehman Brothers Equity Analyst Dan Ford stated in a research report on American
13 Electric Power/Public Service Company of Oklahoma issued on October 10, 2007,
14 "Although the recent denial of the Red Rock plant is likely to reduce the overall capital
15 spent in Oklahoma by AEP in the near future, we remain interested in seeing more states
16 adopt more flexible enhanced recovery programs to account for the increase in capital
17 spending that is already taking place, and to reduce regulatory lag in future years. The
18 combination of this ruling, along with the denial of the Red Rock plant, we believe is
19 indicative of a more challenging regulatory environment in Oklahoma." Even though
20 this particular quote relates to AEP, any perception of a more challenging regulatory
21 environment in Oklahoma would affect all Oklahoma utilities.

1 Q. **Is Lehman's Dan Ford a reputable electric utility analyst?**

2 A. Yes. Dan Ford has been in the business for many years and is one of the most well
3 respected electric utility analysts.

4
5 Q. **Has the Company received additional concerns?**

6 A. Yes. OG&E's management met with Moody's Investors Service ("Moody's"), Standard
7 and Poor's ("S&P"), and Fitch Ratings ("Fitch") in New York City on March 5-6, 2008
8 as part of the Company's Annual Rating Review. During the Fitch meeting, Fitch
9 analysts expressed concern over the possibility of an adverse regulatory environment in
10 Oklahoma based on the Red Rock decision.

11 As a result of that decision, Fitch and the other ratings agencies are closely observing the
12 Commission's conclusions concerning the relief sought for Redbud and OG&E's next
13 general rate case. Representatives of Fitch, Moody's and S&P each specifically indicated
14 that these upcoming proceedings were very important and the outcome could impact
15 OG&E's credit ratings which would increase the cost for the Company's large capital
16 spending program.

17
18 Q. **Do the rating agencies utilize the same methodology to determine these credit
19 ratings?**

20 A. No. However, the various rating agency ratio calculations will be directly and similarly
21 affected by the relief granted in this case or the future rate case.

22 The Commission's focus of my analysis should not be on how the calculations compare
23 to each of the rating agencies. Instead, the Commission's focus should be on the

1 incremental impact to these ratios from not receiving sufficient recovery, initially through
2 the rider and subsequently through permanent rates, for the revenue requirements for the
3 Company's investment in Redbud.

4
5 **Q. Which debt securities are affected if OG&E receives downgrades from credit rating**
6 **agencies?**

7 A. Essentially all types of OG&E's debt instruments, including long-term debt associated
8 with the 6-year construction initiative, the Company's outstanding variable rate industrial
9 authority bonds and short-term debt.

10
11 **Q. Would there be any other impacts?**

12 A. Yes. As mentioned above, a credit rating downgrade negatively impacts the equity
13 market because when a company is viewed by equity investors as more risky, they
14 require a higher return on their investment. This compensation normally occurs in the
15 form of a lower stock price which forces more shares to be issued for capital projects
16 thereby further diluting earnings. This is an illustration of how credit rating downgrades
17 can become a dangerous downward financial spiral.

18
19 SECTION VIII: REGULATORY TREATMENT

20 **Q. Is the rate making relief requested in this case consistent with the overall objective**
21 **of rate regulation?**

22 A. Yes. As part of the regulatory compact between the company and its customers, a
23 regulated utility must be entitled to an "opportunity to earn a fair return" on its prudent

1 utility investments. In order to have this opportunity, a utility must be given the
2 opportunity to recover all costs prudently incurred. In that vein, we believe the
3 Commission should find that our pending investment in Redbud is prudent and that the
4 Facility is used and useful. Upon those findings, it is equitable for the Commission to
5 grant the proposed methodology for recovery of Redbud's revenue requirements.

6
7 **Q. Has the Commission approved recovery riders in conjunction with the preapproval
8 of construction projects?**

9 **A.** Yes. The most recent is the Centennial Wind Energy Project Rider. Subsequent to the
10 Commission issuing OG&E's last general rate review order, the Company developed a
11 wind project that would benefit our customers. OG&E needed a rider to recover financing
12 costs, depreciation expense and operating expenses in order to move forward with the
13 project. The Commission issued an order preapproving the construction of the wind
14 project and the recovery rider. The Centennial rider allowed the Company to mitigate
15 regulatory lag and to move forward with a renewable energy project that will benefit
16 customers for many years.

17
18 **Q. Is there another recent example of a Commission authorized rider?**

19 **A.** Prior to the approval of the Centennial rider, OG&E's Security Rider was approved by
20 the Commission. In the Commission order approving the rider, OG&E was allowed to
21 recover the costs for specific security projects associated with the Company's Homeland
22 Security and Critical Infrastructure Plan as projects were completed, thus mitigating
23 regulatory lag.

1 Q. **Does the proposed rider help OG&E offset regulatory lag with respect to the**
2 **revenue requirements for 2009 caused by the acquisition of Redbud?**

3 A. Yes.

4
5 Q. **Would you provide an example of the Commission mitigating regulatory lag in**
6 **another proceeding?**

7 A. Commission Order No. 470044 authorized OG&E to establish a 12-month regulatory
8 asset when it acquired the McClain Power Plant. The Commission allowed OG&E to
9 accumulate a regulatory asset consisting of non-fuel operation and maintenance expenses,
10 depreciation expense, debt costs, and ad valorem taxes. The order helped mitigate
11 regulatory lag and the effect on the Company's earnings until a rate case could be
12 processed and new rates established and implemented. That decision helped provide
13 OG&E the "opportunity to earn a fair return".

14 Even though the regulatory asset helped mitigate regulatory lag, it did not fully
15 compensate the Company for cash flow or earnings as the costs were incurred or the time
16 value of money during collection of the expenditures as amortized into rates. That is,
17 OG&E was required to: (a) defer the costs without receiving a full rate of return
18 component; and, (b) amortize the regulatory asset without full rate base inclusion of the
19 regulatory asset.

20 In contrast here, OG&E is seeking a rider to provide sufficient cash flow and earnings
21 and to eliminate regulatory lag during 2009.

1 Q. **What regulatory treatment does the Company require to close the Redbud**
2 **transaction?**

3 A. For the reasons discussed by OG&E's witnesses, before the Company proceeds with the
4 Redbud acquisition we need to have certainty the Commission agrees that our investment
5 is prudent and the relief requested in this Application is authorized.

6

7 Q. **Does that complete your testimony?**

8 A. Yes, it does.